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No. 96-1698

IN THE
Supreme Court of the United States
October Term, 1996

INSTITUT PASTEUR AND PASTEUR SANOFI DIAGNOSTICS,

Petitioners,

v.

CAMBRIDGE BIOTECH CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITIONER'S REPLY BRIEF

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18 pp

TABLE OF CONTENTS.

	Page
Summary of argument	1
I. Respondent is mistaken in its assertion that there is no conflict among the circuits regarding the meaning of 11 U.S.C. § 365(c)	1
II. Respondent errs in trying to distinguish every case that supports petitioners	2
III. Contrary to respondent's assertion, the conflict in interpretation has survived the 1984 amendment of Section 365(c)(1)	4
IV. Reversal of the First Circuit in this case will not result in Chapter 11 becoming a "graveyard" for technology companies	7
Conclusion	9

TABLE OF AUTHORITIES

CASES:

Everex Systems, Inc. v. *Cadtrack Corporation* (*In re CFLC, Inc.*), 89 F.3d 673 (9th Cir. 1996)	4
In re Adana Mortgage Bankers, Inc., 12 B.R. 977 (Bankr. N.D. Ga. 1980)	7

Page

In re Antonelli, 148 B.R. 443 (D. Md. 1992), *aff'd without written opinion* 4 F.3d 984 (4th Cir. 1993) 2, 9

In re Carolina Parachute Corp., 108 B.R. 100 (M.D.N.C. 1989) 6

In re CFLC, Inc., 174 B.R. 119 (N.D. Cal. 1994), *aff'd sub. nom., Everex Systems, Inc.* v. *Cadtrack Corp.* (*In re CFLC, Inc.*), 89 F.3d 673 (9th Cir. (1996) 8

In re James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994) 4n

In re Pennsylvania Peer Review Organ., Inc. 50 B.R. 640 (Bankr. M.D. Pa. 1985) 7

In re Plum Run Service Corp., 159 B.R. 496 (S.D. Ohio 1993) 5n, 6, 7

In re West Electronics, Inc., 852 F.2d 79 (3rd Cir. 1988) 3, 4, 6

Institut Pasteur v. *Cambridge Biotech Corp.* (*In re Cambridge Biotech Corp.*), No. 96-40176-NMG (D.Mass. Sept. 27, 1996) 3n

Rieser v. *Dayton Country Club Co.* (*In re Magness*), 972 F.2d 689 (6th Cir. 1992) 3

Summit Inv. and Dev. Corp. v. *LeRoux* (*In re Le Roux*), 69 F.3d 608 (1st Cir. 1995) 4n

Page

STATUTES

11 U.S.C. § 365(c) ..... *passim*

41 U.S.C. § 15 6

MISCELLANEOUS

How to Transfer a Nonassignable Patent License, 17 BANKR. L. LETTER 1, No. 4 (Warren, Gorham & Lamont, April, 1997) 2

King, *Assuming and Assigning Executory Contracts: A History of Indeterminate 'Applicable Law'*, 70 AM. BANKR. L.J. 95 (Spring 1996) 2

Macey and Sacca, *Reconciling Sections 365(c)(1) of the Bankruptcy Code: Should Anti-Assignment Laws Prohibit Assumption of Contracts by a Debtor in Possession?*, 100 COMM. L.J. 117 Summer 1995) 1, 2, 7

SUMMARY OF ARGUMENT

Respondent errs in arguing, inconsistently with every cited commentator and authority that has reviewed the cases, that there is no conflict in the circuits regarding the interpretation of 11 U.S.C. § 365(c). Respondent reaches this unsupported conclusion only by dismissing or distinguishing all cases that evidence this conflict. Where Respondent cannot distinguish the cases on this ground, the conflict is explained away by reference to the particular facts of the cases. However, this only serves to strengthen Petitioner's argument that there exists a divergence of approaches to the interpretation of § 365(c)[1] almost as numerous as the cases found. Further, contrary to Respondent's arguments, the 1984 amendments to the bankruptcy code have not resolved this conflict. There is no risk that Chapter 11 will become a "graveyard" to technology companies if this Court reverses the First Circuit below.

I. RESPONDENT IS MISTAKEN IN ITS ASSERTION THAT THERE IS NO CONFLICT AMONG THE CIRCUITS REGARDING THE MEANING OF 11 U.S.C. § 365(c).

The short answer to Respondent's contention that there is no conflict among the circuits regarding the meaning of 11 U.S.C. § 365(c) is that it is wrong. Not surprisingly, Respondent cites no authority for its creative interpretation of applicable precedent. In contrast, virtually every commentator and authority that has analyzed the opinions of the circuit and lower courts has concluded that the case law is hopelessly divergent and conflicting. *See,* Macey and Sacca, *Reconciling Sections 365(c)(1) and (f)(1) of the Bankruptcy Code: Should*

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[1] Unless otherwise indicated, all statutory references are to the United States Bankruptcy Code, 11 U.S.C. §§ 101-1130, as amended.

Anti-Assignment Laws Prohibit Assumption of Contracts by a Debtor in Possession?, 100 COMM. L.J. 117 (Summer 1995) (hereinafter "Macey & Sacca"); King, *Assuming and Assigning Executory Contracts: A History of Indeterminate 'Applicable Law'*, 70 AM. BANKR. L.J. 95 (Spring 1996); *see also, In re Antonelli*, 148 B.R. 443, 447 (D. Md. 1992), *aff'd without written opinion*, 4 F.3d 984 (4th Cir. 1993).

Indeed, in commenting upon the First Circuit's opinion in this case, one bankruptcy commentator has noted "[u]nfortunately, the conundrum of interpreting 'applicable law' in section 365(c) *continues* to plague the courts." *How to Transfer a Nonassignable Patent License*, 17 BANKR. L. LETTER 1, No. 4 (Warren, Gorham & Lamont, April, 1997) (emphasis added).[2] In short, the conflict among the circuits is severe, and every commentator and court that has reviewed these cases recognizes this conflict.

II. RESPONDENT ERRS IN TRYING TO DISTINGUISH EVERY CASE THAT SUPPORTS PETITIONERS.

The thrust of Respondent's position is that no court has denied assumption where the debtor-in-possession seeking assumption was found to be materially the same entity as the prepetition debtor. Respondent distinguishes every case contrary to its position on various irrelevant factual bases, princi-

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[2] This article is reproduced in the Appendix to this Reply Brief at App. A. As both the title and substance of this article make clear, Petitioners' concern that the First Circuit's opinion below would become a blueprint for evading the long-standing prohibition against nonconsensual assignments of nonexclusive patent licenses has come to pass. Recognizing the interpretive confusion surrounding § 365(c), this article further comments, "many courts have noted, and as this newsletter often has observed, Section 365(c)(1) is fraught with ambiguity and uncertainty." *Id.*

pally on the grounds that many cases cited by Petitioners involve not only assumption, but assignment of the relevant contract as well.

The distinctions Respondent draws are immaterial. First, § 365(c) applies equally to assignment as well as assumption.[3] The statute prohibits "assumption or assignment" where applicable nonbankruptcy law prohibits assignment. The plain language of the statute applies the same standard to determine whether an executory contract can either be assumed or assigned. In either instance, courts are called upon to interpret the phrase "applicable law" in § 365(c) to determine whether the statute prohibits either assumption or assignment. Thus, the cases analyzing the phrase where a debtor seeks both to assume and assign the contract are as meaningful as the cases analyzing the phrase where the debtor seeks to assume, but not assign, the contract. *Compare, In re West Electronics, Inc.*, 852 F.2d 79 (3rd Cir. 1988) (debtor prohibited from assuming contract) *with Rieser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689 (6th Cir. 1992) (trustee seeks to assign contract). Consistently, courts refer to § 365(c) as prohibiting both assumption and assignment, thereby at least implicitly

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[3] Although Respondent now argues cases interpreting § 365(c) where a debtor or trustee seeks to assume as well as assign a contract are distinguishable from cases where only assumption is involved, below Respondent inconsistently conceded that

> § 365(c), by its terms, addresses circumstances in which a trustee is prohibited from both "assum[ing] or assign[ing]" executory contracts. Thus, while [Respondent] disputes that the Plan contemplates an assignment, the provisions in Section 365(c) apply equally to assumption and assignment.

Brief of [Respondent] at 14-15, *Institut Pasteur v. Cambridge Biotech Corp. (In re Cambridge Biotech Corp.)*, No. 96-40176-NMG (D.Mass. Sept. 27, 1996).

rejecting the distinction Respondent draws between cases involving only assumption and cases involving assumption and assignment. *Everex Systems, Inc. v. Cadtrak Corporation (In re CFLC, Inc.)*, 89 F.3d 673, 677 (9th Cir. 1996) (since "a nonexclusive patent license is personal and nondelegable under federal law, § 365(c) bars the "*assumption and assignment*" of the license) (emphasis added).

Thus, the cases cited by Petitioners in their Petition are applicable, and the well recognized conflict described in the Petition is presented to this Court for resolution in this case.

III. Contrary To Respondent's Assertion, The Conflict In Interpretation Has Survived The 1984 Amendment Of § 365(c)(1).

Respondent asserts that the 1984 amendment of Section 365(c)(1) has effectively disposed of any conflict among the circuits concerning the power of the debtor-in-possession to assume executory contracts, and has resulted in a *de facto* legislative override of cases, such as *West Electronics*, that adopt the so-called "hypothetical test." (Opposition 5.) Both assertions are inaccurate.

First, a review of the cases decided subsequent to the 1984 amendment shows that the courts are in conflict in their interpretation of §§ 365(c)(1) and (f)(1), *as amended*.[4] The mean-

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[4] *Compare Summit Inv. and Dev. Corp. v. LeRoux (In re Le Roux)*, 69 F.3d 608 (1st Cir. 1995) (declining to follow hypothetical test and permitting assumption where nondebtor party cannot show it will be deprived of the full benefit of its bargain) *with In re James Cable Partners, L.P.*, 27 F.3d 534, 538 (11th Cir. 1994) ("we conclude that applicable Tennessee law does not excuse the City from accepting performance from an entity other than James Cable, that the 365(c)(1) exception does not apply in this case [as a result], and that James Cable as debtor in possession may *therefore* assume the cable franchise agreement from itself as debtor under 11

ing of the phrase "applicable law" as used in §§ 365(c)(1) and (f)(1), the subject of the conflicting interpretations of § 365(c), is unaffected by the 1984 amendment, since the 1984 amendment did not change the "applicable law" language. Indeed, the amendments furthered, rather than resolved, the conflict regarding the phrase "applicable law" in § 365(c). While the amendments added certain language Respondent relies upon, the amendments did not eliminate the disjunctive application of § 365(c) to either assumption or assignment or delete the reference to "applicable law." Thus, the amendments had no effect on the conflicting interpretations of the phrase "applicable law" in the statute — the phrase that controls the outcome of this case. The cases interpreting the phrase "applicable law" that predate the 1984 amendments remain relevant.

Respondent's reading of the amendment also leads to an absurd reading of the statute as a whole. If, as Respondent contends, the amendment means a debtor-in-possession can always assume the contract when it is the same entity as the prepetition debtor, regardless of whether applicable law prohibits assignment, then § 365(c) would not prohibit assumption where applicable law prohibits assignment. Yet, at least on its face, without the judicial gloss imposed by decisions such as the First Circuit decision below, the statute clearly prohibits either "assumption or assignment" where applicable law prohibits assignment.

Respondent's position effectively amends the statute, since according to Respondent, applicable law is irrelevant to

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U.S.C. § 365(a).") (emphasis added) *and In re Plum Run Service Corp.*, 159 B.R. 496, 501 (S.D. Ohio 1993) (maintenance contract between debtor-in-possession and federal government could not be assumed by debtor-in-possession where federal law would preclude assignment of the contract to a third party).

whether a debtor-in-possession may assume the contract. This is a result clearly at odds with the language Congress chose when it enacted both the original version of § 365(c) as well as the 1984 amendments.

Second, the 1984 amendments did not effect a Congressional override of cases such as *West Electronics* that declare a so-called "hypothetical test." Indeed, *West Electronics* itself interpreted the amended statute and courts have explicitly followed the hypothetical test even after adoption of the 1984 amendments. The court in *In re Plum Run Service Corp.*, in adopting the hypothetical test, cataloged a number of cases that also applied the hypothetical test. There the court explained:

> As noted by the Third Circuit in *Matter of West Electronics, Inc.*, 852 F.2d 79, 83 (3rd Cir. 1988), Section 365(c)(1) creates a hypothetical test: Under applicable law, could the government refuse performance from an entity other than the debtor or the debtor-in-possession? [The r]elevant inquiry is not whether 41 U.S.C. § 15 precludes an assignment from the prepetition debtor to the debtor-in-possession, but whether it would foreclose an assignment from the prepetition debtor to any other contractor. *West Electronics*, 852 F.2d at 83. This reasoning was accepted by the Court in *In re Carolina Parachute Corp.*, 108 B.R. 100 (M.D.N.C. 1989) which noted that both the performance of the debtor as well as the debtor's financial status are irrelevant inasmuch as the plain language of 41 U.S.C. § 15 precludes assumption of a government contract by a debtor-in-possession. Other cases have ruled consistently

> with the *West Electronics case. See, e.g., In re Adana Mortgage Bankers, Inc.*, 12 B.R. 977 (Bankr. N.D. Ga. 1980); *In re Pennsylvania Peer Review Organ., Inc.*, 50 B.R. 640 (Bankr. M.D. Pa. 1985).

In re Plum Run Service Corp., 159 B.R. at 501. Respondent's reference to cases rejecting the hypothetical test serve only to demonstrate yet another source of conflict among the courts in their interpretation of § 365(c). (Opposition 12, n.14.) *See generally,* Macey and Sacca, 100 COMM. L.J. at 124-125 (criticizing cases relying on 1984 amendments to reach result Respondent urges here as inconsistent with text of § 365(c)).

IV. REVERSAL OF THE FIRST CIRCUIT IN THIS CASE WILL NOT RESULT IN CHAPTER 11 BECOMING A "GRAVEYARD" FOR TECHNOLOGY COMPANIES.

Citing no authority, Respondent suggests a "Chicken Little" policy argument supporting its position that the language of § 365 should be ignored and that applicable law is irrelevant despite the language of § 365(c). Respondent claims "[i]f a licensee of United States patents who seeks rehabilitation under Chapter 11 must forfeit its right to assume and carry out its patent licenses, the rehabilitative purposes of Chapter 11 would be defeated and Chapter 11 would be a graveyard for technology companies whose business depends upon continued viability of their patent licenses." (Opposition at 2-3.) Like most nightmares, this assertion has no substance and is not at all frightening when considered in the clear light of day. This bald assertion is false and has been rejected by the courts that have considered it. This assertion also is no justification for a Court to ignore the language of the statute.

In *In re CFLC, Inc.*, 174 B.R. 119 (N.D. Cal. 1994), *aff'd sub. nom., Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996), the debtor made the same bald assertion made by Respondent here. The debtor sought to assume and assign a nonexclusive patent license, such as those at issue in this case. The licensor prevailed on its objection on the grounds § 365(c) prohibits assumption and assignment, since applicable law prohibits nonconsensual assignment of such licenses. On appeal, the debtor argued "bankruptcy policy requires maximization of a debtor's assets and that the result [prohibiting assumption and assignment under § 365(c)] undermines that policy." 174 B.R. at 123. The Court responded by noting "§ 365(c) recognizes that there are other policies in law as well, and the statute expressly subordinates the policy of maximization to those other policies." *Id.* at 123-24.

The debtor then argued, like Respondent here, that the holding jeopardizes the reorganization of all technology-based debtors. The court gave short shrift to this concern, noting "[t]he application of this long-standing federal rule [prohibiting assignment of patent licenses] does not impose *per se* nonassignability; there is nothing in the federal rule to prevent patent holders from conferring assignable licenses to companies willing to pay the additional cost of such licenses." *Id.* at 124. Thus, far from jeopardizing the reorganization of technology based companies, reversing the First Circuit here simply upholds the long-standing federal prohibition against nonconsensual assignments of patent licenses, and prevents a licensee from using the bankruptcy code to obtain the benefits of assignability without paying for them.

More fundamentally, however, Respondent's arguments boil down to the assertion that the bankruptcy policy of maximizing assets and fostering rehabilitation of technology-based debtors should always takes priority over other, perhaps com-

peting, policies embodied in nonbankruptcy law. The conflict among the courts regarding § 365(c) arises because it is under § 365(c) that the courts are asked to weigh these competing policies, all of which are of "substantial weight." *In re Antonelli,* 148 B.R. at 447. This case presents this Court with the opportunity to resolve these conflicts, and to determine whether, as Respondent argues, bankruptcy policy always trumps nonbankruptcy policy, no matter how compelling the nonbankruptcy policy may be.

CONCLUSION

For all the foregoing reasons, Petitioners pray that this Court review this case by writ of certiorari.

Respectfully submitted,

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APPENDIX A

Bankruptcy Law Letter

Vol. 17, No. 4 **April 1997**

How to Transfer a Nonassignable Patent License

AIDS is a terrible disease. However, it has become a source of potentially big dollars for medical firms engaged in the diagnosis and treatment of AIDS. AIDS-related patents can be extremely valuable. Patents, however, generally cannot be assigned without the consent of the patent holder. A chapter 11 debtor discovered a way to circumvent this prohibition — it first *assumed* the patent licenses, then it *sold* its stock to a third party under a reorganization plan. The acquiring third party thus obtained the right to use the assumed patent licenses. The First Circuit rejected the patent holder's objection, ruling that assumption-plus-stock-sale was not the same as assignment. *(Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997).)

The Patent Licenses and the Restrictions on Assignment. Institut Pasteur, a nonprofit French foundation engaged in AIDS-related research. owns patents for procedures to detect the HIV2 virus. Pasteur Sanofi Diagnostics, which holds the exclusive right to use and sublicense those patents, entered into mutual cross-license agreements with Cambridge Biotech Corp. (CBC), in which Pasteur and CBC each acquired a nonexclusive perpetual license to use some of the other's a pat-

ents. CBC obtained the right to use Pasteur's HIV2 procedures in its AIDS diagnostic kits.

These patents could not be assigned or sublicensed without the consent of the patent holder. This broad prohibition is found both in the terms of the license agreements between Pasteur and CBC and in the federal common law of patents. However, the license agreements did permit the licensee to share the benefits of the agreements with any "Affiliated Company." and did not contain provisions conditioning CBC's rights to use the licensed technology in the event of a change of stock ownership.

DeFacto Assignment Argument Found Wanting. Pasteur's worst fear soon came to pass. CBC filed chapter 11 in 1994, and continued operating its retroviral diagnostic testing business, using the Pasteur HIV2 procedures. CBC's confirmed chapter 11 plan provided that CBC would: (i) assume the cross-licenses with Pasteur; (ii) continue operating its diagnostic business; and (iii) sell all of its stock to a subsidiary of bioMerieux. BioMerieux is Pasteur's direct competitor in international biotechnology sales. Pasteur, stunned that its chief rival would be able to use Pasteur's own patents to compete, objected to the plan, arguing that the assumption of the cross-licenses by CBC and the stock sale to bioMerieux was an impermissible de facto assignment of the Pasteur licenses to bioMerieux. The bankruptcy court overruled Pasteur's objection and confirmed the plan, and the district court and court of appeals upheld the confirmation order on appeal.

Section 365(c)(1) limits the ability of a trustee or debtor in possession to assume or assign executory contracts if "applicable law" excuses the nondebtor party to the contract from accepting performance from a third party. As many courts have noted, and as this newsletter often has observed, Section 365(c)(1) is fraught with ambiguity and uncertainty.

Two distinct questions were presented by the facts in the *Cambridge Biotech* case. First, could CBC as the debtor in possession *assume* the patent licenses, given the prohibition on assignment? Second, even if CBC as debtor in possession would be allowed to assume the licenses, did assumption coupled with the stock to bioMerieux constitute a de facto assignment to bioMerieux that would run afoul of Section 365(c)1?

"Actual Performance" Test Adopted for Assumption, "Hypothetical Test" Rejected. The initial question was whether the First Circuit would interpret Section 365(c)(1) to impose an "actual" or a "hypothetical" test for assumption by the debtor in possession. The difference is this. The hypothetical test prohibits assumption and performance by the debtor in possession if applicable law would excuse the nondebtor party from accepting performance from an entity other than the debtor. In other words, under the hypothetical test, if the debtor in possession cannot assign the contract to a third party, the debtor itself cannot assume the contract. Here, since CBC could not assign the patent licenses, use of the hypothetical test would prevent CBC from even assuming those licenses. On this theory, Pasteur would win even without proving that the reorganization plan amounted to a de facto assignment.

Under the actual test, however, assumption will be denied only if performance of the assumed contract by the debtor in possession will in fact deprive the nondebtor party to the contract of the benefit of its bargain. Since the debtor is the very party with whom the nondebtor party contracted, it is usually quite difficult for the nondebtor party to persuade the court that performance by the debtor will eviscerate its contractual expectations. That the debtor hypothetically could not assign the contract to a third party is deemed irrelevant under the actual test, if no such assignment is in fact contemplated. Fol-

lowing its decision in the case *of Summit Investment & Development Corp. v. Leroux.* 69 F.3d 609 (1st Cir. 1995) (discussed in *Bankruptcy Law Letter, January 1996,* at 6), the First Circuit reiterated its preference for the actual test. Given that CBC intended to keep operating the diagnostic business and using Pasteur's patented technology itself, the court found no reason to bar assumption under the actual test.

Stock Sale Does Not Prevent Assumption. Pasteur, however, was not ready to concede defeat, even given the court's utilization of the actual performance test. Pasteur claimed that CBC's assumption did deprive Pasteur of the benefit of its bargain, by reason of the fact that CBC sold all of its stock to bioMerieux, a chief competitor of Pasteur. Because of this stock sale, CBC was no longer the same entity that Pasteur contracted with, Pasteur alleged. Furthermore, the practical effect of the assumption-plus-stock-sale would be to assign the patent license to a third party — a result that plainly could not be effected directly.

The First Circuit had little sympathy for Pasteur's plea, for several reasons. First. under basic principles of corporate law, a transfer of stock ownership does not affect or alter the separate legal status of the corporation itself. Continuity of life is a fundamental aspect of corporate status. Thus, nothing in the mere sale of stock affected the rights of the debtor in the licensed technology. Second, Pasteur could have protected itself from the effects of a change in CBC's ownership by careful drafting of the license agreements. Those agreements could have limited or terminated CBC's license rights in the event its stock were to change hands, but they did not do so. The generic prohibition on assignment did not have such a global effect. Furthermore, the license agreements even recognized the right of CBC to share the benefits of the licensed

technology with any "Affiliated Company," which would include a parent company.

WG&L Thoughts. The *Cambridge Biotech* case is another chapter in the continuing saga of the problems raised by the collision in bankruptcy reorganization cases between the needs to promote the ends of the reorganization, on the one hand, and to protect the legitimate contractual expectations of the nondebtor party to a contract with the debtor, on the other. As have many cases before it, *Cambridge Biotech* takes a pragmatic view of whether any concrete harm has been inflicted on the nondebtor party, eschewing hypertechnical solutions that serve only to mask the real issues. Unfortunately, the conundrum of interpreting "applicable law" in Section 365(c) continues to plague the courts. (For a useful discussion, see Brett W. King, "Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law," 70 Am. Bankr. L.J. 95 (1996). Interestingly, the First Circuit in *Cambridge Biotech* suggested that Pasteur could have drafted around its problem, through the adroit use of change-of-ownership provisions in the license agreements, but one wonders whether such provisions would be honored in a chapter 11 case if the effect were to deprive the estate of valuable contractual rights. Such provisions seem analogous to contractual anti-assignment clauses, which are not given effect in bankruptcy (see Section 365(f)).